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First Destination Transportation: The Case for a Consistent Funding Policy

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EXECUTIVE SUMMARY

Current funding policies for first destination transportation costs distinguish between shipments made under free on board (FOB) origin and those made under FOB destination terms. This paper presents the case for a consistent funding policy for both. Specifically, FOB origin shipments should be funded in the same manner as shipments made FOB destination--the cost of shipment should be financed by the same funds that were used to acquire the item regardless of shipment terms. This approach is logical, consistent with generally accepted accounting principles, and alleviates several problem at the execution level, including potential Anti-Deficiency Act violations, unmatched disbursements, and unnecessary workload. The paper includes recommended actions necessary for SAF/FMB to implement this policy change.

TABLE OF CONTENTS

First Destination Transportation: The Case for a Consistent Funding Policy

Introduction

Current funding rules for first destination transportation are inconsistent, and vary based on the terms of shipment. Specifically, transportation of assets shipped free on board (FOB) destination is financed by the same appropriation used to acquire the item. On the other hand, transportation of assets shipped FOB origin may be financed in various ways: with the same funds used to acquire the item; with funds of the same appropriation but of a different fiscal year; or with a different appropriation entirely. These policies for FOB origin shipments create significant difficulty at the execution level. Problems include increased potential for Anti-Deficiency Act violations, unmatched disbursements, and additional workload for accounting adjustments and contract modifications. A funding policy which finances both FOB origin and FOB destination transportation with the same funds used to acquire the item could alleviate these problems and make Air Force accounting practices more consistent with generally accepted accounting principles. The following paragraphs discuss this issue in greater detail by defining key terms, describing the current policy, discussing the problems the policy creates, providing the conceptual basis for a change in policy, and outlining the actions needed to implement a change.

Definition of Terms

Several terms are important to a discussion of transportation funding. **First destination transportation (FDT)** is the movement of an asset from a supplier or

manufacturer to a Government facility. FDT shipments may be either free on board (FOB) destination or FOB origin. **FOB** terms determine the point where ownership passes from seller to buyer and are the basis for payment of freight charges. Under **FOB destination**, title passes to the buyer at the shipment's destination point. The seller bears the transportation cost and assumes the risk for loss or damage in transit. Sellers usually include this cost in the end item price. Under **FOB origin**, title passes from seller to buyer at the point of initial shipment. Although sellers sometimes prepay transportation costs for FOB origin shipments, the buyer is ultimately responsible for this cost as well as any loss or damage in transit. When contractors prepay transportation costs under FOB origin terms, they bill this cost and obtain reimbursement under a separate line item on the contract invoice. Funding policies vary based on which shipment terms are used.

Current Policy

The Federal Acquisition Regulation (FAR) authorizes the contracting officer to select the method of shipment for Government procurements based on overall cost and perceived advantage to the Government. Although FOB destination terms are generally preferred (3:2), contracting officers may select FOB origin to obtain a lower end item price or increase delivery flexibility. FOB origin sometimes offers lower overall cost because the Government assumes the risk for loss or damage during shipment. FOB origin also provides advantages when items require special handling or when delivery destinations are not firmly established. In fact, the FAR requires FOB origin when destinations are uncertain (8:47-15).

Funding policy depends on the transportation method (FOB destination or FOB origin) selected by the contracting officer. Under FOB destination, transportation costs are charged to the same appropriation that financed the acquisition (1:132). On the other hand, if the contract specifies FOB origin terms, transportation costs are financed as follows:

- The Air Force Other Procurement Appropriation (3080) finances items acquired with Aircraft (3010), Missile (3020), or Other Procurement (3080) funds;

- The Research, Development, Test and Evaluation (RDT&E) appropriation (3600) finances items acquired with RDT&E funds; and

- The Operations and Maintenance (O&M) appropriation (3400) finances items acquired with O&M funds (1:132).

Although these policies appear straightforward, guidance in Air Force Regulation (AFR) 170-8 adds a significant complication. Specifically, paragraph 14 of this regulation states, "Transportation is an obligation of the fiscal year (FY) in which the bill of lading is issued to a commercial carrier" [emphasis supplied] (2:16). In other words, an item ordered and funded from the FY 1995 O&M account but delivered in FY 1996, requires FY 1996 O&M funds to pay transportation costs. However, if the same item is ordered and shipped FOB destination, an exception applies. According to AFR 170-8, "Transportation of government supplies is an obligation of the same FY in which the supplies are purchased if the transportation is included in the price of the materiel being purchased (when the purchase is being made FOB destination)" [emphasis supplied]

(2:16). In other words, the transportation cost for an asset shipped FOB origin may be financed by a different year as well as a different appropriation than used to acquire the item. On the other hand, if that same asset is shipped FOB destination, transportation costs are an obligation of the same funds which purchased it.

Interim Message Change 92-4 to AFR 177-102 contains another important directive requirement. It requires contracting officers to obligate vendor prepaid freight costs (i.e., FOB origin) as a cost of the contract. This requirement, however, is extremely difficult to implement because of the funding policies described above. When combined, these policies pose several problems at the execution level.

Problems with the Current Policy

Current funding policies for FOB origin shipments cause difficulty for the contracting as well as disbursing activities, including increased potential for Anti-Deficiency Act (ADA) violations, disbursements unmatched to obligations, and increased workload for contract funding actions and accounting adjustments. The following paragraphs provide additional details.

ADA violations can arise in one of two ways. First, by awarding a contract that includes FOB origin deliveries in a subsequent year, the contracting officer is essentially obligating the Government for transportation payments from an appropriation that does not yet exist. This may constitute an obligation in advance of an appropriation, a violation of the time statute (31 USC 1551). Strict adherence to AFR 170-8 would require each contract specify shipment only to those items which can be delivered during

the current fiscal year, and subsequent contract modifications to direct shipment for all deliveries which occur later. Such intensive management of every contract would significantly increase the workload of the ordering activity, presuming the rate of delivery is even known or can be determined in sufficient time to program, budget, and obligate the necessary funds.

An ADA violation can also occur if the contracting officer fails to accurately predict the actual rate of delivery in subsequent years, and does not obligate sufficient funds to properly align transportation funding with deliveries as they occur. Estimating transportation cost in total is difficult, but not nearly as challenging as aligning this total with specific time periods to match the rate of delivery. Accurate funding alignment requires specific information such as date of contract award, production schedules, and delivery destinations to be available as early as the budget formulation phase. Since FOB origin is often used when delivery requirements are tentative or unknown, the buying activity is unlikely to have this information when needed. Even if available, an unanticipated slippage in the contract award date, unforeseen production delays, or developmental problems could significantly alter the delivery schedule. As a result, contract obligations may be insufficient to cover actual transportation costs and a potential ADA violation exists.

To alleviate this problem, the contracting officer could restrict shipments until the necessary information is available, contracts are modified, and funds properly aligned with projected deliveries. However, such an approach may not satisfy operational

requirements for critical support items. Instead, delivery schedules should be based on contractor production capability and operational needs of the supported activity, not the financial process.

Potential ADA violations are not the only problem caused by the current policy. If FOB origin deliveries are made and billed without a corresponding contract obligation, the disbursing office has an unmatched disbursement. If paid, such disbursements create additional workload to research and eventually correct the accounting records. On the other hand, if the disbursing office withholds payment until appropriate funding adjustments are made, the Prompt Payment Act (31 USC 3902) may apply and interest costs accrue until final payment.

Either way, the rules for funding FOB origin shipments create a significant and unnecessary workload for the buying activity as well as the disbursing office, and place both in an untenable position. The contracting activity cannot easily or accurately predict actual freight costs and ensure funds are available in the proper accounting period. The disbursing office can either pay the transportation invoice as an unmatched disbursement, or withhold payment and allow interest to accrue until the proper funds are obligated. These problems could be solved by a consistent funding policy for both methods. Specifically, eliminate the distinction between FOB origin and FOB destination shipments, and fund both with the same appropriation (including fiscal year) that was used to acquire the item. This approach is logical, conceptually sound, and consistent with generally accepted accounting principles.

<u>Conceptual Basis for a Change in Policy</u>

From a logical standpoint, if there is a valid requirement for an item, there is also a requirement for its eventual delivery. In this context, the timing of delivery is immaterial because the delivery requirement must exist at the outset. If that is the case, the rules for full funding should apply. Under full funding (applicable to the procurement appropriations), "An item is full-funded only when funds are programmed and available to cover the total estimated cost of the item when procurement is initiated" (4:9). A central question, therefore, is whether transportation is an integral part of the total item cost when it is incurred under FOB origin terms (and therefore not included in the end item price).

Accounting theory supports inclusion of transportation as part of cost whether or not it is included in the item price, an approach that applies both to fixed (capital) assets as well as consumable inventory. For example, Kiger, Loeb and May state, "The cost of *any* asset is the sum of *all* expenditures necessary to acquire the asset and place it into its intended use. The term *intended use* is understood to include factors of location and condition for use" (7:328). Similarly, Kieso and Weygandt describe the cost of depreciable equipment to include not only its purchase price, but also other accessorial costs including freight and handling charges (6:475).

Neither of the above sources distinguish between the FOB terms under which transportation charges are incurred. From a standpoint of asset valuation, there is no difference. Transportation is an integral element of asset value whether included in the

end item price (FOB destination) or paid separately (FOB origin). Therefore, the Air Force could eliminate this distinction and have a funding policy that is logical, conceptually sound, and fully consistent with asset valuation under generally accepted accounting principles.

Conclusion

The preceding discussion described the problems an inconsistent transportation funding policy creates at the execution level. The Air Force can obtain several benefits by eliminating the funding distinction between FOB origin and FOB destination, and financing all first destination transportation from the same appropriation that acquires the asset. Specific benefits include reduced potential for ADA violations, workload reduction, and enhanced flexibility in selecting the most advantageous shipping terms.

Recommendations

SAF/FMB should revise Air Force funding policies for FOB origin transportation costs. Both FOB origin and FOB destination costs should be funded by the same appropriation used to acquire the item shipped. Appropriate revisions to financial management directives, including AFI 65-601 and AFR 170-8, should be processed through the applicable offices of primary responsibility. SAF/FMB should also revise budget preparation guidance to ensure budget estimate submissions include FOB origin transportation costs consistent with this funding policy.

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